2012 Mutual Funds and Investment Management Conference

Current Tax Developments

March 19, 2012

Current Tax Developments – Panelists

- Keith Lawson – ICI (moderator)
- Shawn K. Baker – PricewaterhouseCoopers LLP
- Julie Henderson – Dimensional Fund Advisors LP
- Monette Nickels – ALPS Fund Services, Inc.
- Ronald Dabrowski – Internal Revenue Service

Topics to be Covered:

- Foreign Account Tax Compliance Act ("FATCA")
- International Investing Tax Issues
- Commodity Funds
- RIC Modernization Act Implementation

FATCA Introduction

- FATCA effectively is designed to require certain FFIs that hold U.S. investments to:
  - enter into agreements with IRS;
  - identify U.S. taxpayers – including direct and indirect accountholders;
  - report to IRS on these taxpayers; and
  - withhold 30 percent on certain payments to "recalcitrant account holders" and FFIs that do not meet FATCA requirements.

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February 8, 2012 Developments

- Proposed FATCA regulations released
  - Comment requested by April 30
- Joint Statement of U.S. and Five European Nations
- Timeline for additional guidance provided:
  - Draft "Foreign Financial Institution ("FFI") Agreement to be released in Spring 2012
  - Final FATCA regulations to be released in "the summer" of 2012

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New Reporting Requirements

- Reporting still begins in 2013 (but with gradual implementation)
- Less information required to be reported during 3-year transition period
  - For 2013 and 2014 calendar years, only customer identity, account number and account balance
  - For calendar year 2015, income as well
- All statutorily-required information not reportable until calendar year 2016

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New Withholding Requirements

- One-year delay – until January 1, 2014 – for withholding on “ordinary” income (such as dividends and interest)
- Two-year delay – until January 1, 2015 – for withholding on gross proceeds
- Four-year delay – until January 1, 2017 – for withholding on “foreign passthru payments”

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Identifying U.S. Persons

- Preexisting individual accounts
- New individual accounts
- Preexisting entity accounts
- New entity accounts

FFI Agreement Certifications

- "Responsible officer" of FFI must certify that:
  - written compliance policies and procedures adopted;
  - periodic internal compliance reviews will be conducted; and
  - certifications and other information will be provided periodically to allow IRS to determine whether FFI has met its obligations

"Deemed Compliance"

- Registered Deemed-Compliant FFI
- Certified Deemed-Compliant FFI

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Obligations of a Registered Deemed-Compliant FFI

- Responsible officer certification that FFI meets requirements for deemed-compliant status
- Obtain IRS confirmation of registration and identification number ("FFI-EIN")
- Passthru payment percentage obligation?
- Renew certification every three years
- Notify IRS of any change affecting its registered deemed-compliant FFI status

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Types of Registered Deemed-Compliant FFIs

- Types of registered deemed-compliant FFIs:
  - Local FFIs
  - Nonreporting Members of PFFI Groups
  - Qualified Collective Investment Vehicles ("CIVs")
  - Restricted Funds
  - FFIs that comply with requirements under an agreement between the U.S. and a Foreign Government (but actual registration with IRS may not be required)

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Certified Deemed-Compliant FFIs

- Certify to withholding agent (on IRS Form W-8) that it meets deemed-compliant status requirement; IRS registration NOT required
- Types of certified deemed-compliant FFIs:
  - Nonregistering local banks
  - Retirement funds
  - Non-profit organizations
  - FFIs with low-value accounts
  - Certain owner-documented FFIs

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Retirement Funds

- Several rules are provided to reduce or eliminate FATCA's application to retirement funds
- Accounts held by certain retirement funds are excluded from the definition of a financial account
- Certain retirement funds also may qualify as:
  - certified deemed-compliant FFIs or
  - exempt beneficial owners

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Joint Statement Regarding Inter-Governmental Approach

- The United States and five countries (France, Germany, Italy, Spain, and the United Kingdom) issued a joint statement regarding an intergovernmental approach to improving international tax compliance
- The six countries commit to working with the Organization for Economic Cooperation and Development ("OECD") and others

INTERNATIONAL TAXATION

- Treaty Benefits and Developments
  - Increased withholding rates in certain markets and increased documentation requirements to receive benefits
    - Belgium - WHT on interest and dividends increased to 21% from 15%
    - France -WHT on dividends increased to 30% from 25%
    - Japan - 'Reconstruction Special Inc. Tax' will phase in and increase the withholding tax on dividends to 15% by January 2038 from 7%
    - Portugal – WHT on dividends and interest income increased to 25% from 21.5%
    - Spain - WHT on dividends and interest income increased to 21% from 19%
    - South Africa – new 15% withholding tax effective April 1, 2012.

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INTERNATIONAL TAXATION

- Treaty Benefits and Developments
  - Germany requires applicable transparency declarations on percentage of underlying investors applicable to the tax treaty claim being made *at each ex-date of a dividend event* and shares outstanding on that date.
  - Canada will soon require fund declarations (Jan 1, 2013)
  - Austria is currently clarifying requirements of documentation in specific cases (in addition to attestations)
  - Timing of Certificates of Residency (IRS Form 6166)
    - Changes in 'grace periods' in certain markets - Poland, Italy, Germany, Switzerland, Austria, France, Portugal Spain no longer apply a grace period.
    - Late certificates of residency will result in treaty benefits being denied at source (will need to file reclaims).

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INTERNATIONAL TAXATION

- Treaty Benefits and Developments (Continued)
  - Korea
    - In January, the Korean Ministry of Finance released draft guidance for funds seeking to receive benefits under any applicable treaty with Korea.
    - The guidance becomes effective on July 1, 2012, and provides treaty-benefit eligibility and documentation requirements for qualifying offshore collective investment vehicles ("OCIVs").
    - ICI letter requested clarification on how OCIV rules apply to start-up funds and master-feeder fund structures and raises some concerns with the timing for additional guidance.

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INTERNATIONAL TAXATION

- Treaty Benefits and Developments (Continued)
  - Italy
    - Significant US investor claims for refunds of Italian WHT have been outstanding for years (estimated at more than $95 million).
    - AGC initiated a formal Request for Competent Authority Assistance to the IRS on February 8, 2011.
    - Certain global custodian banks have recently notified clients that they will no longer accrue Italian reclaims receivable.
    - Recent updates indicate that ITA, in line with their 2012 plan previously communicated, started disposing tax reimbursement for foreign corporations and financial institutions.

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INTERNATIONAL TAXATION

- Treaty Benefits and Developments (Continued)
  - India
    - The Indian tax authorities have been assessing tax against funds for unreported income arising from trades on the Bombay Stock Exchange ("BSE").
    - The BSE's trade date information is incomplete and/or inaccurate and doesn't allow the tax authorities to reconcile the BSE's trade data with the income reported on the funds' tax returns (which uses settlement date).
    - In January, ICI sent a letter to the BSE requesting that the BSE modify the process by which it provides transaction data to the Indian tax authorities, specifically that the BSE provide transaction data based upon settlement date rather than trade date.

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INTERNATIONAL TAXATION

- Capital gains taxes
  - Certain markets imposing CGT at certain 'significant' ownership thresholds. General trend upward in the number of countries imposing CGT.
  - Capital gain analysis for a RIC should begin with the application of domestic law. If domestic law taxes capital gains, look to treaty for protection. However, treaty may not apply because:
    - The tax treaty between the U.S. and the source country permits the source country to tax capital gains (India);
    - Investment in real property holding companies are not treaty protected (Japan, South Africa, South Korea, France);
    - Investment in land-rich companies; (Australia)
    - Investment exceeds certain ownership thresholds (Israel, Mexico, Norway);
    - Source country may not recognize a RIC as a "resident" under the treaty (Norway).

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INTERNATIONAL TAXATION

- EU Reclaims (Article 56 Claims)
  - Many EU countries waive withholding taxes on dividends for their own residents, but not for non-residents; it's this concept of discrimination that forms the basis for these claims.
  - Potentially billions of dollars at stake for US RICs (estimates as high as $15 billion)
  - Recent Updates:
    - Netherlands – Entities resident in qualifying 3rd countries that are exempt from profits tax in their home country are now eligible for a full refund of Dutch WHT to the extent the WHT relates to portfolio dividends (effective 1/1/12).
    - France -Test case referred to ECJ by French Supreme Tax Court. ECJ heard case on 2/16/12. Ruling expected within 3 months.

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INTERNATIONAL TAXATION

- EU Reclaims (Article 56 Claims) - Continued
  - Recent Updates:
    - Germany – Final decision of the ECJ with regard to corporations who do not fulfill the requirements of the parent-subsidiary directive (PSD) to be entitled for WHT refund under PSD.
    - Finland – Central Tax Board issued negative advance rulings regarding a US investment fund.
    - Norway – Life insurance companies no longer exempted from tax on dividends and gains and will now be taxed at 28%. Losses are now deductible.
    - Sweden - Administrative Court of Appeal concluded that a Luxembourg FCP should not suffer WHT in Sweden. Decision has been appealed.

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INTERNATIONAL TAXATION

- PFIC Update
  - Certain securities which may be held in US equity portfolios are deemed to be PFICs. Typically these are companies traded on US exchanges but incorporated off-shore (Bermuda, BVI, etc.).
  - Difficulty with PFIC identification causes so called 'late identified PFICs' to be a focus for many in the industry.
  - Increased shareholder demand for QEF elections creates additional costs and complexity for offshore products with US investors.

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Alternative Investment Strategies: Commodity Funds

- Direct investment in commodities, including commodity swaps and commodity futures, constitutes non-qualifying income under IRC Section 851(b)(2)
- Indirect investment in commodities achieved one of two ways:
  - Commodity Linked Notes (CLN)
  - Controlled Foreign Corporation (CFC) subsidiary
- Investments subject to limitations under IRC Section 851(b)(3)
- PLRs issued on CLN/CFC structure
  - Income from CLN/CFC qualifying under IRC Section 851(b)(2)

Alternative Investment Strategies: Commodity Funds (cont)

- "Pause" by IRS in issuance of PLRs on CFCs/CLNs
  - Awaiting public guidance addressing CFCs/CLNs upon which all taxpayers can rely
- 1/26/12 hearing by Permanent Subcommittee on Investigations
  - "Compliance with Tax Limits on Mutual Fund Commodity Speculation"

Alternative Investment Strategies: MLP Funds

- Investments in MLPs generally limited under IRC Section 851(b)(3) to 25% of total assets
- Funds investing entirely in MLPs taxed as C-corporations
- Significant tax considerations include:
  - Timing of inclusion of income from Schedule K-1s
  - DTA/DTL accruals
  - Federal tax liability
  - State Income/Franchise Tax exposure
  - Compliance with Rule 19a1 of the '40 Act
  - Corporate Organizational Action Reporting – Form 8937

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RICs of Hedge Funds

Structuring, Planning and Operational Considerations

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RICs of Hedge Funds
Structuring – Planning - Operational Considerations

Why are RICs being used as master funds?

Benefit – simplicity of tax reporting (1099 Forms vs. K-1s)

Burdens –

- Losses do not flow through
- Requirement to pay dividends
- More withholding on foreign investors
- Character conversion of capital gain to ordinary income

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RICs of Hedge Funds
Structuring Considerations

Structuring – Open-end versus closed-end RIC

Structuring – The Hedge Fund Investment

- Direct investment in US hedge fund
  - Qualifying income test – "bad income" flows through
  - Qualifying asset test – RIC likely deemed to own hedge fund assets
  - Taxable income - reflected on Form K-1

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RICs Hedge Funds
Structuring Considerations (cont'd)

- Investment in offshore hedge fund
  - Facilitates qualification and taxable income determinations
- Indirect investment through offshore blocker (if no offshore fund available)
  - Proper structuring of the blocker to be respected as a corporation for US tax purposes
  - Qualifying income test – "bad income" blocked
  - Qualifying asset test – blocker is a stock holding subject to 25% test and is likely a "bad" asset for the 50% test
  - Taxable income considerations similar to commodity fund blocker

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RICs of Hedge Funds
Planning Considerations

- Convert Existing Fund to a RIC - Tax Recognition Considerations for Partnership and Partners
  - Partnership master fund to RIC
  - Liquidation of US direct hedge fund interest
  - Contribution of hedge funds to foreign partnerships
- Year end selection
- Gaining agreement with hedge fund advisors to provide information
  - Qualifying and non-qualifying gross income
  - Assets
  - Taxable income for excise tax purposes

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RICs of Hedge Funds
Tax Operational Considerations

- Gross income test and asset diversification test
  - Information from underlying hedge funds
    - Frequency and need for detailed information
- Taxable income
  - Domestic hedge funds
    - Year end selection to afford time to receive partnership K-1
    - Excise tax information
  - Offshore hedge funds – treatment as PFICs
    - Mark-to-market election
    - Qualified electing funds
  - Offshore blocker funds (same as commodity funds)

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RIC Modernization Implementation Considerations

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RIC Modernization Implementation Considerations

Savings Provisions

Gross Income Test

- Tax on non-qualifying income above threshold
- Reasonable cause and not willful neglect

- **Asset Diversification Test**
  - Access to the new provisions – do not meet the old cures
  - What are de minimis failures?
  - If non-de minimis failure
    - What assets caused the failure?
    - Requirement to report those assets on a schedule
    - Determining the "net income" from those assets
    - Reasonable cause and not willful neglect
  - How are discrepancies "cured"

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RIC Modernization Implementation Considerations

Taxable Income Provisions

Unlimited Carryover of Capital Losses

- Effective date for excise tax purposes

- **Late Year Losses**
  - **Capital Losses**
    - Prior Law – mechanical rules with little planning opportunity
    - New Law
      - Planning opportunities under certain fact patterns
      - Tax efficiency versus prior law varies widely depending on fact patterns
      - Need for tight tax operational controls

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RIC Modernization Implementation Considerationsations

Taxable Income Provisions

- **Late Year Losses**
  - **Ordinary Losses**
    - Funds can now defer combined post-October "specified losses" and post-December "other ordinary losses"
    - Considerations
      - Determining specified versus non-specified ordinary loss items
      - Deferral may be more limited than prior law as post-December net investment income is included in the calculation
      - Difficult to estimate tax returns of capital for many international fixed income funds that pay regular distributions

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RIC Modernization Implementation Considerations

Other Provisions

- **Preferential Dividend Rule Repeal**
  - Determining which funds are "publicly offered"
  - Key considerations for publicly offered multiple class funds' expense structure now under the 1940 Act

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Current Tax Developments

Questions

and

Answers

Current Tax Developments

Thank You!